DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 02-0242
Indiana Gross Income Tax
For the Years 1998, 1999, and 2000

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ISSUES

I. **Mutual Fund Commissions Received in an Agency Capacity** – Gross Income Tax.

Authority: IC 6-2.1-2-2(a)(1); IC 6-2.1-2-2(a)(2); Policy Management Systems Corp. v. Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999); Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994); 45 IAC 1.1-1-2; 45 IAC 1.1-1-2(b)(1); 45 IAC 1.1-1-2(b)(2); 45 IAC 1.1-6-10.

Taxpayer argues that it was not subject to Indiana gross income tax on commission payments attributable to the sale of mutual fund shares to Indiana customers.

II. **Abatement of the Ten-Percent Negligence Penalty**.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer maintains that it had reasonable cause for initially believing that the commission payments it received were not subject to Indiana gross income tax and that – as a result – the ten-percent negligence penalty should be abated in its entirety.

STATEMENT OF FACTS

Taxpayer is an out-of-state licensed mutual fund broker registered with the Securities and Exchange Commission (SEC) to sell mutual fund shares. However, it does not itself sell mutual fund shares to individual customers but operates through a network of independent agents who deal directly with the individual customers.

The parties' mutual fund business works like this. There are five parties to each sale of a mutual fund share: 1. the Indiana customer; 2. the independent agent; 3; the insurance company 4; taxpayer (mutual fund broker and licensee); and 5; the agency/broker. The independent agent sells a mutual fund share to an Indiana customer. The customer sends the money to the insurance company which has the capacity to assemble and manage the mutual fund. The insurance company sends a portion of the money – in the form of a commission – to taxpayer which, by

virtue of its SEC registration, has the authority to market the mutual fund share. Taxpayer keeps one portion of the commission for itself but sends another portion of the commission amount to the agency/broker. The agency/broker – which deals with the individual independent agents – keeps a portion of the commission but also pays a portion of that amount to the independent agent who originated the sale.

The Department of Revenue conducted an audit review of taxpayer's 1998, 1999, and 2000 business records. The audit determined that taxpayer should have been paying Indiana gross income tax on the commissions it received from the insurance company including that portion of the commissions which it did not retain but which it paid over to the agency/broker. Accordingly, the audit concluded that it owed additional tax and assessed the amounts accordingly.

Taxpayer disagreed with the audit's determination on the ground that the commissions – that portion paid over to the agency/broker and thence to the independent agents – was "received in an agency capacity and should be excluded from [taxpayer's] gross income." Taxpayer submitted a protest setting forth that argument, an administrative hearing was conducted during which taxpayer's representatives further explained the basis for the protest, and this Letter of Findings results.

DISCUSSION

I. Mutual Fund Commissions Received in an Agency Capacity – Gross Income Tax.

Taxpayer's position is that it is not subject to gross income tax on that portion of the commissions it receives from the insurance company but pays over to the agency/broker and the independent agents. To illustrate; an Indiana customer purchases a mutual fund share and pays $100 to the insurance company. The insurance company retains $70 of that amount and pays $30 to taxpayer as a cumulative, three-stage commission amount. Taxpayer receives the $30, keeps $10 for itself, and pays $20 to the agency/broker. The agency/broker receives the $20, keeps $15 for itself – its own commission – and pays $5 to the independent agent who originally sold the mutual fund share to the Indiana customer.

Originally, taxpayer reported none of these commissions – the $30 cited above – as gross income. However, taxpayer now admits that the commission amount which it retains for itself – the $10 cited above – should have been reported as subject to gross income tax. However, it argues that not *all* of the commission amount it receives from the insurance company is part of its gross income. Taxpayer maintains that the amount which it pays over to the agency/broker – $20 in the example above – was received in an agency capacity and should not be included in its gross income.

Indiana imposes a gross income tax upon the entire gross receipts of a taxpayer who is a resident or domiciliary of Indiana. IC 6-2.1-2-2(a)(1). For the taxpayer who is not a resident or domiciliary of Indiana, the tax is imposed on the gross receipts which are derived from business activities conducted within the state. IC 6-2.1-2-2(a)(2). However, 45 IAC 1.1-6-10 exempts that

portion of the taxpayer's income which the taxpayer receives while acting in an agency capacity. 45 IAC 1.1-1-2 defines an "agent" as follows:

> (a) "Agent" means a person or entity authorized by another to transact business on its behalf.
>
> (b) A taxpayer will qualify as an agent if it meets both of the following requirements:
>
> > (1) The taxpayer must be under the control of another. An agency relationship is not established unless the taxpayer is under the control of another in transacting business on its behalf. The relationship must be intended by both parties and may be established by contract or implied from the conduct of the parties. The representation of one (1) party that it is the agent of another party without the manifestation of consent and control by the alleged principal is insufficient to establish an agency relationship.
> >
> > (2) The taxpayer must not have any right, title, or interest in the money or property received from the transaction. The income must pass through, actually or substantively, to the principal or a third party, with the taxpayer being merely a conduit through which the funds pass between a third party and the principal.

The Indiana Tax Court in Policy Management Systems Corp. v. Indiana Department of State Revenue, 720 N.E.2d 20 (Ind. Tax Ct. 1999) and Universal Group Limited v. Indiana Department of State Revenue, 642 N.E.2d 553 (Ind. Tax Ct. 1994) reviewed the relationship between the imposition of the state's gross income tax and agency principles, echoed the standards set out in 45 IAC 1.1-1-2 and 45 IAC 1.1-6-10, and found that an agency relationship required consent by the principal, acceptance and authority by the agent, and control of the agent by the principal.

Taxpayer has provided a copy of a "selling agreement." The "selling agreement" sets out the relationship between the insurance company, taxpayer, and the agency/broker. These three parties are collectively referred to as the "selling entities." Taxpayer's contention is that the commission money which it receives from the insurance company and then forwards to the agency/broker is received in an agency capacity for gross income tax purposes. Taxpayer points to the terms of the "selling agreement" as supporting this assertion. In particular, taxpayer points to that portion of the "selling agreement" labeled "compensation." That section of the agreement states, "[Insurance company], through [taxpayer], will remit to [agency broker] compensation as set forth the applicable Compensation Schedule hereto, which payments or termination thereof shall be governed by the administrative rules established by the administrative rules established by [insurance company] in its sole discretion."

It is apparent that taxpayer is required to forward to the agency/broker certain commissions earned from the sale of the mutual fund shares. Clearly, taxpayer would be in violation of the parties' agreement if taxpayer were to unilaterally decide to retain for itself the commissions due to agency/broker. It is also clear that the insurance company – and not the taxpayer – has the "sole discretion" to establish the "administrative rules" governing the procedures by which the

commission payments are forwarded to the agency/broker. However, taxpayer falls far short of establishing that the commission payments intended for the agency/broker – and thence to the individual, independent agents – were received while it was acting in an agency capacity for the insurance company.

The regulation defining the agency relationship has two components. The first requires that the taxpayer, as the putative agent, establish that is under the control of the principal and that the parties intend to create an agency relationship by that control. 45 IAC 1.1-1-2(b)(1). Taxpayer has provided nothing which establishes that taxpayer (the putative agent) and the insurance company (the putative principal) intended to create an agency/principal relationship and that these two parties were anything more that two distinct business entities which entered into an agreement which made it possible for the insurance company to sell shares of its mutual fund to Indiana customers. The argument fails because taxpayer has introduced nothing which demonstrates that taxpayer was under the control of the insurance company or that the insurance company made itself liable for the taxpayer's business decisions.

Even if it could be established that taxpayer and the insurance company intended to create an agent/principal relationship, the regulation defining that relationship for gross income tax purposes has two components. The second requirement is that the taxpayer not have any right to money received in the transaction but that the income received from the principal "pass through" to the third party. 45 IAC 1.1-1-2(b)(2). The Indiana Tax Court has described that requirement as follows.

> The lesson of Ice Service, Associated Telephone, and Western Adjustment, as discussed in UGL I, is that there is no gross income tax liability for an agent when: 1) the agent, acting in an agency capacity, receives income in which the agent has no right, title, or interest, and; 2) the agent subsequently "passes through" the income to a principal or a third party. Universal Group, 642 N.E.2d 553, 555-56.

Clearly, all the parties to the "selling agreement" intended that the insurance company would pay commissions to the sellers when shares of its mutual funds were sold to Indiana customers. The "selling agreement" also makes it plain that the commissions would be paid "through" the taxpayer. However, there is nothing which establishes that taxpayer had "no right, title, or interest" in the commissions which were owed to the agency/broker. Taxpayer owed the agency/broker the commission payments; however, taxpayer at some point took control over those amounts, and – however briefly – exercised control and dominion over those same amounts.

In sum, taxpayer's argument fails because there is no indication that the insurance company and taxpayer ever intended to create an agency/principal relationship and because there is no indication that the commissions passed through to the agency/broker without taxpayer having some – albeit transitory – degree of beneficial interest in those amounts. "To be outside the gross income tax, there must be *both* and agency and pass through, actual or constructive." Universal Group, 642 N.E.2d at 557 (*Emphasis added*).

FINDING

Taxpayer's protest is respectfully denied.

II. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer failed to report any of the commission income it received from the insurance company as subject to gross income tax. Taxpayer argues that it had good cause for failing to report the commission income and that its decision not to report the income was supported by a reasonable interpretation of the applicable law and regulations.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . ."

Taxpayer has set forth a facially valid argument that it was not subject to gross income on the commissions that it forwarded to the agency/broker and the individual, independent agents. However, taxpayer's apparent determination that it did not owe gross income tax on *any* of the commissions is entirely unwarranted. The decision that it did not owe gross income tax on its own portion of the commissions attributable to the sale of mutual fund shares to Indiana customers is not indicative of the "reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." 45 IAC 15-11-2(b).

FINDING

Taxpayer's protest is respectfully denied.

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